

# How to Use Cost-Plus Pricing in Marketing

## Introduction

One of the possible approaches to setting prices in marketing is using a cost-plus pricing formula. As the name suggests, is a combination of costs and plus a markup percentage. The markup percentage is to ensure profitability for the business.

One of the main benefits of this pricing approach is that it ensures that products are always priced above the total cost involved in producing and supplying the product to the customer. This means that, in theory at least anyway, the business will always be profitable and will never inadvertently sell a product at a loss to a customer.

Another benefit of cost-plus pricing is its "simplicity". However, this benefit of simplicity comes primarily from its calculation – which is its total cost multiplied by a markup percentage. For example, a product that costs \$10 to the business, and then is marked up by 80%, delivers a price to consumers of \$18.

While that is a relatively simple calculation, the complexity of cost-plus pricing comes from the identification of costs and the correct allocation of costs to each product. Therefore, your task in this challenge is to correctly allocate costs to each product line, and then calculate the final retail price for a hamburger chain.

## Your Pricing Task

Let's assume that you are a pricing analyst in the marketing department of a large fast-food chain. Your manager has requested that you set prices for the main products offered by the business. In particular, you need to set the prices for the following products:

- cheeseburger
- deluxe hamburger
- fries
- soda drinks (e.g. Coke)
- coffee

## Ingredient Costs

To help you with your task, you have been provided with the following ingredients costs for each product:

- cheeseburger: cheese = \$0.12, meat patty = \$0.60, bun = \$0.09, sauce = \$0.03, packaging = \$0.15
- deluxe hamburger: cheese = \$0.15, meat patty = \$1.10, bun = \$0.14, sauce = \$0.05, salad items = \$0.22, packaging = \$0.20
- fries: potatoes = \$0.17, salt = \$0.01, packaging = \$0.12
- soda drinks: beverage = \$0.19, packaging = \$0.12, straw = \$0.02

- coffee: coffee beans = \$0.68, milk = \$0.07, sugars/flavorings = \$0.04, packaging = \$0.25

### **Fixed Costs**

There are numerous fixed costs involved in running a fast-food chain, and you have been provided with the following information regarding WEEKLY costs:

- rental cost = \$5,000
- cleaning, security = \$1,000
- kitchen and asset repairs = \$500
- electricity, gas = \$500
- advertising/promotion = \$1,000
- insurance, banking fees = \$250
- various other costs = \$750

Your manager has advised you that you need to allocate these costs evenly across the five product lines. In other words, each product line must cover 20% of the above costs when you calculate your prices using the cost-plus pricing formula.

### **Staff Costs**

Probably what you notice missing from the above fixed costs is staff costs. These have been presented separately here, even though in most cases they are a fixed cost (although sometimes they are referred to as a semi-variable cost because staff members can go up and down with demand).

The reason they are presented differently is because your manager has advised you that these costs need to be allocated based upon the amount of staff time that is spent on each product line, which will be further clarified below.

- weekly staff costs = \$12,000

As indicated the staff costs need to be allocated to each product line on a staff time basis, as follows:

- cheeseburger = 20% of staff time
- deluxe hamburger = 40% of staff time
- fries = 10% of staff time
- soda drinks (e.g. Coke) = 10% of staff time
- coffee = 20% of staff time

## Regular Weekly Sales Levels

Each week (relatively consistently) this fast-food store sells the following volume (number of units) of each product line:

- cheeseburger = 8,000 units
- deluxe hamburger = 4,000 units
- fries = 12,000 units
- soda drinks = 16,000 units
- coffee = 2,000 units

## Student Discussion Questions

1. What is the variable cost for each product line?
2. What is the total fixed and staff costs to be covered by each product line? Divide that by the number of units to be sold, and what is the amount of fixed costs that need to be covered per individual product sale?
3. Therefore, what is the TOTAL cost of each product to the business – adding up variable costs, allocation of fixed costs, and allocation of staff cost?
4. If you use a percentage markup of 100% for the cheeseburger and deluxe hamburger, and a markup of 50% for the fries and the soda drink, and a 200% markup for the coffee – what are the retail prices that should be set for each product?
5. Looking at the cheeseburger product only. If variable costs were to double, what would happen to your cheeseburger profits using this pricing approach? Would they go up or down? Does this make sense?
6. Based on your knowledge of pricing (your reference prices) are these prices likely to be competitive and attractive to consumers?
7. What is your assessment of the cost-plus pricing approach? Do you think, from a marketing perspective, that it is a good approach to pricing products for consumers?